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Municipal Bond Market in India

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ABSTRACT *The demand for funding urban infrastructure services in India has increased many folds due to rapid urbanization. Accessing capital markets has emerged as viable options for Urban Local Bodies (ULBs) to finance urban infrastructure. Since 1997, Several ULBs and utility organizations have issued municipal bonds and have mobilized over . 12, 000 million through taxable bonds, tax-free bonds and pooled financing scheme. However, after 2010, no municipal bonds were issued and the market has been effectively dead due to low ratings, reluctant investors and unclear regulation. But the GOI is making every effort to revive municipal bond market to meet the mounting funding requirements of rapid urbanisation.*

MUNICIPAL BOND MARKET IN INDIA

- **Introduction**

The fiscal reforms initiated at the center since 1990's had put considerable pressures on the state finances, by reducing grants, subsidies, loans, and other forms of transfers from the central government. Again the economic reform had their own way for the private sector participation in the provision of urban infrastructure and civic services, thereby to an extent also amplified the capabilities and resource base of the Urban Local Bodies (ULBs). At the same time, a growing urban population has been creating additional demands on infrastructure and services, requiring both short-term funds for their maintenance as well as long-term funds for producing additional facilities.

As part of the Jawaharlal Nehru National Urban Renewal Mission (JNNURM), GoI has made some efforts to enable ULBs to access the bond market. Since 1994, the Indo-US Financial Institution Reform and Expansion (FIRE-D) project is working with national, state and local governments in India to develop a market-based municipal bond market. Several ULBs and utility organizations in India have issued municipal bonds that so far have mobilized over ₹.12,884 million through taxable bonds, tax-free bonds and pooled financing (Vaidya et al 2008). The Government of India (GOI), recognizing infrastructure's key role in the process of economic development, set up the expert group on the commercialization of Infrastructure, often known as the Rakesh Mohan Committee, in 1994. The FIRE-D project worked closely with this Committee to provide international experience on tax-free municipal bonds. The Committee recommended private sector participation in urban infrastructure development and accessing capital markets through issuing municipal bonds.

- **Concept and type of Municipal Bond**

Municipal bond is a bond issued by a city or other local government, or their agencies. It is an evidence of the debt obligation of a ULB to repay a fixed principal amount on a certain maturity date along with the interest, at a stated or formula-based rate (Dirie, 2005). Potential issuers of municipal bonds include cities, counties, redevelopment agencies, special-purpose districts, school districts, public utility districts, publicly owned airports and seaports and any other governmental entity (or group of governments). Municipal bonds may be general obligations of the issuer or secured by specified revenues. Interest income received by holders of municipal bonds is often exempt from the federal income tax and from the income tax of the state in which they are issued, although municipal bonds issued for certain purposes may not be tax exempt. Proceeds of municipal bonds are usually used for infrastructural development like, building schools, highways, hospitals, sewage systems, and many other projects for public welfare.

The two basic types of municipal bonds are:

General obligation bonds: Principal and interest are secured by full faith and credit of the issuer and usually guaranteed by either the issuer's unlimited or limited tax paying power.

Revenue bonds: Principal and interest are secured by revenues of ULBs derived from tolls, charges or rents from the facility built with the proceeds of the bond issue. Public projects financed by revenue bonds include toll roads, bridges, airports, water and sewage treatment facilities, hospitals and subsidised housing.

- **Need of Municipal bond for financing Urban infrastructure**

As India rapidly urbanizes urban governance and administration in general, and meeting the financial needs of urban areas in particular, has acquired greater urgency. In India by 2030, 590 million will live in cities, more than double the corresponding number in 2001 (Sankhe et al. 2010); 91 million urban households will be middle class with expectations of better quality and quantity of urban amenities; According to the Report on Indian Urban Infrastructure and Services (2011), between 2012 and 2031, India will need to invest ₹. 39,187 billion (US$ 835 billion) at 2009–10 prices, equivalent to 46 per cent of the country's 2012 GDP to meet its urban infrastructure requirements. In sharp contrast, the report estimated that for 2012-13, India's municipal expenditure would be equivalent to only 1.53 per cent of GDP, and less than a third would be met from own revenue sources (ibid).

Infrastructure financing needs of municipalities and other ULBs in India have traditionally been met from grants and transfers from higher levels of government, state-owned institutions, and to a little extent by bilateral and multilateral agencies providing grants and loans. By the mid-1990s, ULBs comprehended that these sources of funds were no longer sufficient to cater to their increasing infrastructure requirements. The local bidies need to acquire much greater capabilities in obtaining resources from both conventional sources, such as property tax, profession tax, cost recovery, user charges, entertainment tax and license fees; and non-conventional sources e.g. improving the net use value of land and other real estate, innovatively designing new property rights and using existing rights more effectively, deploying human resources more productively, treasury management, various modes of public-private partnerships (PPPs) and most importantly municipal bonds.

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- **Benefits of Municipal Bond**

Municipal bonds have advantages in terms of the size of borrowing and the maturity period which may extend up to 20 years. Both these features are suitable for urban infrastructure financing. Further, if properly structured, municipal bonds can be issued at interest costs that are lower than the risk-return profile of individual. The municipal bond mode of financing allows both the borrowers and the lenders to have greater flexibility. Local government bond issuers are likely to be less restricted by annual budget cycles and the capital grants' decisions of higher levels of government (Mehta and Satyanarayana, 1999). Further, they can unbundle their functions, which enables them to make separate decisions about the placement of their liquid deposits and about obtaining advice regarding the financial and/or technical components of their infrastructure projects (Peterson, 2003). However, it should be noted that the danger of such unbundling is that a credit partner who understands various aspects, especially the financial impacts of different activities of the ULB on each other, would be absent (Peterson, 2003). The flexibility available to the lenders arises out of the possibility of trading municipal bonds prior to the end of their tenor in the secondary bond market. Liquidity in such a market is essential for the development of the primary municipal bond market.

However, the advantages of municipal bond market can only be realized when a sound fiscal and regulatory framework is structured for developing the market. Such a framework would clarify various aspects of this market, such as ex ante borrowing activities of ULBs, ex post procedures regarding municipal default and insolvency, and domains that involve shared responsibilities between different levels of government in a federal state (GoI, 2011).

- **Trend of Municipal Bond Market in India**

Bangalore Mahanagara Palike was the first ULB to have raised resources through private placement of municipal bonds in 1997 and Ahmadabad Municipal Corporation was the first to make a public offering in January, 1998. It issued ₹.1,000 million in bonds to partially finance a ₹.4,390 million water supply and sewerage project. Since 1998, other cities that have accessed the capital markets through municipal bonds without state government guarantee include Nashik, Nagpur, Ludhiana, and Madurai (Table 1). In most cases, bond proceeds have been used to fund water and sewerage schemes or road projects. Till 2010, only 28 municipal bond issues have taken place in India, which have included both taxable and tax-free bonds and pooled financing issues. Most of these have been private placements rather than public offers. A look at the trend in the value of municipal bond issues since 1997 suggests that the value of municipal bond issuances that were on a rise till 2005 has seen a sharp fall since then and there has been very few issuances since 2007 and practically no issue after 2010 (Khan, 2013). Since 1999-2000, for further growth of the municipal bond market, the Government of India allowed ULBs to issue tax-free municipal bonds. In view of this, the central government amended the Income Tax Act (1961 vide the Finance Act 2000), whereby interest income from bonds issued by local authorities was exempted from income tax. The GOI issued guidelines for issue of tax-free municipal bonds in February 2001. Tax-free status provided a motivation to local governments to improve their fiscal management sufficient enough to meet the demands of the investment community.

Table 1: Status of Taxable Municipal Bond in India

Name of Municipal Corporation / (Year of issue)	Amount (in ₹. Million)	Placement	Guarantee	Annual Interest	Escrow	Purpose	Rating
Bangalore Municipal Corporation (1997)	1,250	Private	State Govt.	13%	State Government grants and property tax	City roads/ street drains	A- (SO)
Ahmadabad Municipal Corporation (1998)	1,000	Public & Private	No	14%	Octroi from 10 octroi collection points	WS&S project	AA- (SO)
Ludhiana Municipal Corporation (1999)	100	Private	No	13.5% to 14%	Water & Sewerage taxes and charges	WS&S Project	LAA- (SO)
Nasik Municipal Corporation (1999)	1,000	Private	No	14.75%	Octroi from four collection points	WS&S project	AA- (SO)
Indore Municipal Corporation (2000)	100	Private	State Government	13.0%	Grants/property tax	Improvement of city roads	A (SO)
Nagpur Municipal Corporation (2001)	500	Private	No	13%	Property tax and water charges	WS project	LAA- (SO)
Madurai Municipal Corporation (2001)	300	Private	No	12.25%	Toll tax collection	City road project	LA+(SO)
Visakhapatnam Municipal Corporation (2004)	200	Private	No	7.75%	Property tax	Water supply project	AA-(SO)

Source: Chetan Vaidya & Hitesh Vaidya, 'Creative financing of Urban Infrastructure in India through market based financing and public private partnership', 2008.

Ahmedabad municipal corporation (AMC) was the first ULBs in India to issue tax-free municipal bonds for water and sewerage projects. In April 2002, AMC issued a tax-free 10-year bond with an annual interest rate of 9.00 percent. The issue amount was ₹.1,000 million. A list of tax free municipal bond issued so far is given in table -2 below

Table - 2: Status of Tax-free Municipal Bond in India

Name of the Municipal Corporation	Year of issue	Purpose	Amount of Tax-free Municipal Bond (₹. million)
Ahmedabad Municipal Corporation	2002	Water supply and sewerage project	1,000
Nashik Municipal Corporation	2002	Underground sewerage scheme and storm water drainage system	500
Hyderabad Municipal Corporation	2003	Road construction and widening	825
Hyderabad Metropolitan Water Supply and Sewerage Board	2003	Drinking water project	500
Visakhapatnam Municipal Corporation	2004	Water supply system	500
Chennai Metropolitan Water Supply & Sewerage Board	2003	Chennai water supply augmentation project	420
Ahmedabad Municipal Corporation	2004	Water supply project, storm water drainage project, road project, bridges and flyovers	580

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Chennai Metropolitan Water Supply & Sewerage Board	2005	Chennai water supply project	500
Chennai Municipal Corporation	2005	Roads	458
Ahmedabad Municipal Corporation	2005	Roads and water supply	1,000
Nagpur Municipal Corporation	2007	Nagpur water supply and sewerage project	212
Greater Vishakhapatnam Municipal Corporation	2010	Greater Vishakhapatnam water supply project	300

Source: Chetan Vaidya & Hitesh Vaidya, 'Creative financing of Urban Infrastructure in India through market based financing and public private partnership', 2008 and H.N. Khan 'Financing Strategy for Urban Infrastructure: Trends and Challenges', 2013.

In India, only financially strong, large municipal corporations are in a position to directly access capital markets. Cost of transaction and a poor balance sheet restrict most of the small and medium size ULBs to access capital markets. In the United States and some of the European countries, small local bodies pool their resources and jointly access the capital market. Based on this model, the Governments of Tamil Nadu and Karnataka issued municipal bonds by pooling municipalities. In 2003, the Tamil Nadu Urban Development Fund issued a bond by pooling 14 municipalities for commercially viable water and sewerage infrastructure projects. Subsequently, the Government of Karnataka used the concept of pooled financing to raise debt from investors for the Greater Bangalore Water Supply and Sewerage Project (GBWASP). The success of the pooled finance model in Tamil Nadu and Karnataka had subsequently led the Government of India to create a central fund that enables capital investments to be pooled under one state borrowing umbrella. FIRE-D project supported GoI's vision in formulating the Pooled Finance Development Fund (PFDF) Guidelines to help small- and medium-sized ULBs access market funds for their infrastructure projects.

- **Conclusion**

A vibrant market for municipal bonds can go a long way to help provide long-term funding for India's urban infrastructure requirements - as in the US, where the related market had over $3.7 trillion outstanding in early 2012. But the market has been effectively dead in India. Greater Vishakhapatnam Municipal Corp issued the last municipal bonds in India in 2010. India's municipal bond market faces hurdles of low ratings, reluctant investors and unclear regulation. Most municipal corporations in India have a limited understanding of bond market. Again, the bigger and better-rated municipalities are flush with funds and, as such, are naturally reluctant to turn to the debt markets. Others, especially the lower-tier and mid-tier municipalities, have no access to bond markets and mostly rely on state-owned Housing and Urban Development Corp for their funding needs. Capacity building is the biggest hurdle for the municipal bond market in India. Investors may still have concerns about the ability of municipalities to increase revenues and fund themselves due to regular political interference.

However, GOI is making every effort to revive its municipal bond market to meet the mounting funding requirements of rapid urbanisation. Some weaker municipal bodies, such as those in Tamil Nadu and Karnataka, have successfully experimented with pooled financing structures. The bigger municipal bodies should be encouraged to issue bonds so that a yield curve is created for others to follow. The central government is also closely following a World Bank report on the regulatory framework for municipal borrowing in India. This indicates the fortitude of the government to promote the market in a better way in the coming days.

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